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Kurt R. Sjoberg
Acting Auditor General

May 14, 1990

P-939

Honorable Elihu M. Harris, Chairman
Members, Joint Legislative
Audit Committee
State Capitol, Room 2148
Sacramento, California 95814

Dear Mr. Chairman and Members:

On April 25, 1990, the Office of the Auditor General released "The California Museum of Science and Industry Needs To Modify Its Agreement With Its Foundation and Improve Management Controls" (P-939). Attached is a response we received from the California Museum Foundation of Los Angeles (foundation) after the issue date of the report. By agreement with the foundation, we are forwarding the foundation's response to all parties who received the report.

The foundation believes the report contains "serious inaccuracies and misstatements." However, after reviewing the foundation's response and the documentation we compiled during the audit, we stand by the report, which is factually accurate as written. In the following paragraphs, we provide a brief overview of the foundation's response, clarifying each major concern.

The first ten pages of the response are primarily background information on the history of the foundation and its relationship with the museum. In this background section and in subsequent pages, the foundation objects to what it perceives as a general understatement of the foundation's contributions to the museum. While we acknowledge the foundation's significant contributions to the betterment of the museum (see pages 3 and 11 of the report), the foundation overstates its contributions to the museum. Following are the key issues raised by the foundation and our comments to each of them.

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Foundation's Response

The foundation states that private sector funds it raised have funded all but one of the museum's exhibits.

Auditor General's Comments

While various exhibits have been developed solely through the efforts of foundation staff, others have been the result of joint efforts by museum and foundation staff. Still other exhibits have been developed solely through the efforts of museum staff. Further, state funds as well as private funds have gone into these projects, and at least one exhibit was funded exclusively with public funds.

Foundation's Response

On page 12, the foundation criticizes the report for failing to recognize the foundation's having raised the funds for three major exhibits opened in the past year.

Auditor General's Comments

The foundation was not the sole fund-raiser for two of these exhibits. In fact, no foundation staff were involved in raising funds for one of the exhibits. The foundation also fails to cite the State's contribution to major educational programs at the museum. At the top of page 4, the foundation states that private sector funds it raised have funded major educational programs. However, by far the largest funding for educational programs comes from the State. According to the Governor's Budget, of the more than \$7.87 million estimated to be spent on these programs in fiscal year 1990-91, \$7.5 million (95 percent) will come from the State.

Foundation's Response

As further evidence of the report's alleged understating of the foundation's contributions, the foundation provides a table claiming over \$21 million in contributions it solicited from foundation fiscal years 1984 through 1989.

Auditor General's Comments

As cited in the report, we reviewed the progress of specific projects and sources of foundation support for the last two years. However, our review of who solicited funds for specific projects and our review of the foundation's audited financial statements indicate

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that the table does not accurately portray the foundation's recent fund-raising activity. As stated on page 11 of the report, regardless of who raises the funds, the foundation reports all contributions it receives as support and revenue (or as deferred revenue) on its annual financial statements. Further, for financial statement presentation, the foundation recorded all of a \$3 million contribution as income in foundation fiscal year 1987, the year it was pledged. However, in the table the foundation breaks the contribution into \$1 million increments covering each of the past three fiscal years. While the payments were made in three \$1 million installments, the actual fund-raising activity took place in 1987. Therefore, the foundation's table is not a true reflection of its recent fund-raising activity.

Foundation's Response

On page 10, the foundation attempts to discount our concern regarding a potential dispute over the distribution of assets upon dissolution. The foundation states that "...despite the ominous statements in the Report, the State of California's access to the Foundation's assets is not in jeopardy."

Auditor General's Comments

In our report, we say that the State's immediate access could be disputed, not that it is in jeopardy, based on the foundation's legal counsel's interpretation of language in the November 1989 agreement. According to this interpretation, the foundation would be required to distribute only part of its assets to the museum. If the foundation does not wish to follow its counsel's interpretation, one could reasonably expect the foundation's assurance to be followed by its changing the November 1989 agreement and its articles of incorporation to eliminate any dispute regarding the distribution of all assets to the museum. The foundation further attempts to discount the potential dispute by implying that the California Corporations Code Section 6716 assures the State that its access to the foundation's assets is guaranteed since the state attorney general must approve the distribution of a California public benefit corporation's assets upon dissolution. While the attorney general has a right to object to a dissolution, our legal counsel has stated that the foundation could nevertheless petition a court to sustain its counsel's interpretation of the dissolution provisions. The potential for litigation on this issue is therefore not removed by the participation of the attorney general.

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Foundation's Response

At the top of page 11, the foundation rejects as "flatly and unequivocally not true" our observation that the foundation appears not to be meeting an important provision of the agreement: to exert its best efforts to raise funds to further the museum's purposes.

Auditor General's Comments

The foundation's statement on page 11 conflicts with statements it makes on page 7 that, following disruptive events in 1989, "the Foundation's Executive Committee recommended that the Foundation could not in good conscience continue to solicit contributions that would be subject to transfer to the State Agency [the museum], or perhaps to the general fund of the State of California....Pending a meeting of the full board of the Foundation, its Executive Committee felt forced to terminate all fund raising activities until the issues were resolved. It is true that some contributions were received....No new efforts were made to solicit contributions."

The foundation's concerns also include other aspects of the report. We have reviewed these comments and find no merit to them. If you or members of the committee have questions regarding the report or the foundation's response, the audit team will be available to discuss them.

Sincerely,



KURT R. SJOBERG
Acting Auditor General

Attachment

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Re California Museum Foundation/Your Report P-939

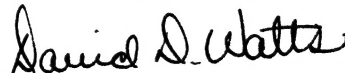
Dear Mr. Sjoberg:

Enclosed are two copies of the California Museum Foundation's Response to your Report P-939. Pursuant to the assurance given to us by Ms. Mary P. Noble, Deputy Auditor General, we request that you forward copies of this Response to all persons who received copies of the Report.

As set forth in the introductory paragraph of the Response, the California Museum Foundation now will undertake to prepare a more detailed response dealing with each particular statement in the Report with which the Foundation disagrees.

Thank you very much for your courtesy and cooperation.

Very truly yours,



David D. Watts
of O'MELVENY & MYERS

DDW:jg
Enclosures

Response Of
CALIFORNIA MUSEUM FOUNDATION

To
Report By The Office
Of The
Auditor General
P-939

The California Museum Of Science And Industry
Needs To Modify Its Agreement With Its
Foundation And Improve Management Controls

On April 12, 1990 the California Museum Foundation (the "Foundation") received a draft of Report P-939 (the "Draft Report"). In its April 11, 1990 letter transmitting the Draft Report to the Foundation, the Auditor General's office gave the Foundation a deadline of 5:00 p.m., April 18, 1990 to respond in writing to the Draft Report. By telephone, the Foundation's legal counsel was offered an additional day within which the Foundation could respond in writing. The Foundation concluded that only a partial written response was possible by the April 18th (or the April 19th) deadline. On April 16, 1990 representatives of the Foundation and its legal counsel met with two members of the Auditor General's staff to discuss what the Foundation believes were serious inaccuracies and misstatements in the Draft Report, and the Foundation's legal counsel confirmed in writing for the Auditor General's staff some of the points raised in that meeting, with the expectation that

some of the inaccuracies and misstatements in the Draft Report would be corrected. Most were not corrected. On April 17, 1990 the Foundation's President, Marvin L. Holen, wrote to the Auditor General's office as follows:

"Kurt R. Sjoberg
Acting Auditor General
660 J Street, Suite 300
Sacramento, California 95814

Re: Museum of Science and Industry

Dear Mr. Sjoberg:

Thank you for sending us a copy of the portions of the April 1990 draft of "The California Museum of Science and Industry Needs to Modify its Agreement with its Foundation and Improve Management Controls."

Although the California Museum Foundation finds numerous inaccuracies and is in substantial disagreement with the contents and conclusions of the portions of the draft report we received, we believe that the April 18, 1990 deadline gives us insufficient time to respond properly in writing.

Please be assured that we will respond in writing, and fully, to the report when we have received a copy of the final version.

Very truly yours,

Marvin L. Holen
President, Board of Trustees"

This document constitutes a formal written response to the final version of the report (the "Report"), which final version was received by the Foundation on April 25, 1990. This response is not intended to refute each inaccurate statement in the Report. A more detailed

refutation is in progress, but this response is intended only to set forth the Foundation's general disagreement with the Report, and to deal with a few of the more egregious misstatements about the Foundation which, if not refuted, may lead to serious misunderstanding of the Foundation's tremendous contributions to the California Museum of Science and Industry in Exposition Park (the "Museum"). It should be noted that the Draft Report and the Report both use the term "Museum" to refer to the agency of the State of California technically known as the Sixth District Agricultural Association. This Response refers to that entity as the "State Agency" and refers to the complex of buildings and exhibits in Exposition Park as the Museum.

I

HISTORICAL PERSPECTIVE:

THE FOUNDATION IS LARGELY RESPONSIBLE FOR THE CURRENT SUCCESS OF THE CALIFORNIA MUSEUM OF SCIENCE AND INDUSTRY

For approximately 35 years, the State Agency and the Foundation (a private, nonprofit public benefit corporation) enjoyed the reputation of having been the most successful public-private partnership in the State of California. This reputation was well deserved.

The Foundation's fund raising activities have been very successful, with the result that private-sector funds contributed through the Foundation and its various support groups have been responsible for: the construction of four of the seven Museum buildings, plus very substantial capital improvements; the establishment of all but one of the exhibits; and the establishment of major educational programs, such as the Summer Science Workshop, Science Fair, and Science on Stage. There were performances of Science on Stage for 66,486 students and adults in 1989 alone (see IV below - schedule of contributions received since October, 1983).

In the early 1950's, Governor Goodwin J. Knight asked a group of prominent Los Angeles business and civic leaders to accept appointment to the Board of Directors of the Sixth District Agricultural Association, which comprised Exposition Park and included a small, under-utilized agricultural museum. The new Board of Directors quickly ascertained that the building of a major, nationally renowned science museum would require the support of the private sector to supplement basic support provided by the State of California. The California Museum Foundation, a non-profit corporation, was formed, and the partnership was established through an operating agreement between the State Agency and the Foundation.

It soon became apparent that the partnership could best be successful operating as a single entity with a common policy and senior staff. Where State Agency funds were not adequate to provide additional staff, the Foundation stepped in and provided staff support. Where the needs of the Museum could not be met by the Foundation, efforts were made to persuade the State of California, through the legislature and the governor, to meet those needs. This fully-cooperative effort drew little distinction between staff employed directly by the State Agency, staff employed directly by the Foundation, and some senior staff employed by both. Particularly important was the Foundation's ability to supplement the salaries for the top staff so that the partnership could attract highly qualified persons to senior positions.

In 1987, the former long-time State Agency Executive Director/Foundation Executive Vice President retired. On the State Agency side he had occupied the exempt position provided under state law and normally filled by the chief executive officer of a state agency. On the Foundation side he held the senior staff position. The Foundation recommended that a nationwide search be conducted for a person of major national and international reputation to fill the joint position being vacated. The Foundation agreed to provide a supplementary salary which would have brought the combined State Agency and Foundation

compensation into the \$150,000 per annum range. In addition, the Foundation agreed to provide appropriate housing. The Foundation hoped to attract a person who would have already established entry to the world's largest corporations and foundations, someone who by reputation would attract major gifts to the Museum. The Foundation sought to bring to the Museum the best that could be had -- to make a quantum leap in providing education opportunities in the world of science and industry for the children and adults of California. Obviously, to attract such a person, it would be necessary to continue the custom of a single chief executive for the Museum partnership.

II

THE DISRUPTIVE EVENTS OF 1989 CAUSED A SERIOUS SETBACK

In 1989, the State Agency filled its exempt position with a new deputy director, foreclosing the opportunity to find nationally-recognized leadership. The State Agency's action seriously disrupted the State Agency's relationship with the Foundation. That disruption led, in part, to legislative concern, resulting in the language added to the 1989 budget bill directing the State Agency: (1) to give notice of termination of the operating agreement with the Foundation; and (2) not to enter into a new agreement with the Foundation unless that agreement

contained explicit provisions - indeed an unusual legislative action. The State Agency failed to take a position on this matter.

In discussing how to react to the anticipated notice of termination, the Foundation became acutely aware of a provision of the operating agreement stating that all assets of the Foundation would go to the State Agency upon final termination of the operating agreement. This provision had been little noticed during the many years of success by the partnership. In light of that provision, when faced with a legislatively mandated notice of termination, the Foundation's Executive Committee recommended that the Foundation could not in good conscience continue to solicit contributions that would be subject to transfer to the State Agency, or perhaps to the general fund of the State of California. The solicitation and receipt of contributions would be under false pretenses. Pending a meeting of the full board of the Foundation, its Executive Committee felt forced to terminate all fund raising activities until the issues were resolved. It is true that some contributions were received. Those contributions resulted from considerable previous efforts and were being accepted conditionally and put into a special account so that a contributor could determine the ultimate charitable disposition of the contribution should there be a complete rupture between the State Agency and the Foundation. No new

efforts were made to solicit contributions. Further, the notoriety attending the difficulties at the Museum appeared to cause many major contributors to defer or turn aside from support. Competition in Southern California for philanthropic giving is fierce, and the goodwill established over the years by the Foundation's Trustees with business leaders and private foundations was damaged.

On July 19, 1989 the full board of the Foundation's Trustees met. On the agenda was the issue of how to respond to the anticipated notice of termination from the State Agency. The Foundation's Executive Committee recommended that actions be taken to insure that the Executive Committee would have the maximum authority to deal with any issues arising as a result of the notice of termination and the possibility of difficulties with the State Agency in any negotiations over a new operating agreement.

The Foundation, at its July 19, 1989 meeting took the following two actions:

First, as mentioned on page 10 of the Report, the Trustees authorized but did not direct the officers of the Foundation to prepare appropriate legal documents for dissolution of the Foundation.

Second, the Trustees approved amendment of the Foundation's Articles of Incorporation to revise Article (f) to provide as follows:

"(f) Upon the dissolution or winding up of this corporation, after paying or adequately providing for the debts and obligations thereof, the trustees, officers, or persons in charge of the liquidation shall transfer, assign, and convey to the Sixth District Agricultural Association the exhibits and rights to concessions in trust for the education of the people of California and the rest of the assets, real or personal, of every kind and character, to any nonprofit scientific, educational, or charitable public foundation qualified under Section 501(c)(3) of the United States Internal Revenue Code for support of the California Museum of Science and Industry in Exposition Park."

III

A NEW BEGINNING -

THE NOVEMBER, 1989 "INTERIM" AGREEMENT

Between August and November 1989 the Foundation and the State Agency negotiated the terms of a new agreement. In those negotiations, both the State Agency and the Foundation considered it to be an interim agreement,

pending resolution of some outstanding issues, including that of distribution of assets of the Foundation in the event of liquidation or in the event of termination of the agreement with the State Agency. Since the November 1989 agreement is viewed as an interim agreement, no further action has been taken by the Foundation with regard to dissolution, or with regard to further modification of its Articles of Incorporation. Nevertheless, despite the ominous statements in the Report, the State of California's access to the Foundation's assets is not in jeopardy. The Foundation intends to honor its November, 1989 agreement to distribute all assets to the state. Moreover, pursuant to California Corporations Code §6716, distribution of a California public benefit corporation's assets upon dissolution must be approved by the California Attorney General.

The State Agency has acknowledged that the new agreement represented a new beginning and that over the months to come a further agreement will be negotiated, taking into consideration the issues which had surfaced during the period of instability.

IV

CONTRARY TO THE REPORT, THE FOUNDATION CONTINUES
TO PROVIDE VERY SUBSTANTIAL SUPPORT FOR THE
MUSEUM AND TO FUND EXHIBITS AND OTHER PROJECTS

The Report asserts that the Foundation is not exerting its best efforts to raise funds for the Museum. That is flatly and unequivocally not true. The following six-year schedule of contributions commencing with 1984 indicates the substantial impact of Foundation activities:

<u>Fiscal Year Ending</u> <u>September 30</u>	<u>Contributions Received*</u>
1984	\$ 6,528,000
1985	850,000
1986	1,858,000
1987	4,070,000
1988	2,858,000
1989	<u>3,667,000</u>
Subtotal:	\$19,831,000
Deferred Revenue at September 30, 1989	<u>1,189,000**</u>
Total Contributions for Period October 1, 1983 through September 30, 1989	<u>\$21,020,000</u>

*This excludes rent revenue received from McDonald's and the Gift Center of \$386,000, Gannett Outdoor of \$45,000, Urban Environment funds received from government agencies of \$80,000, and \$250,000 received for removal for asbestos. It also excludes any funds relating to the "explainer" contracts referred to on page 28 of the Report.

**The Foundation had received \$1,189,000 of contributions which were recorded as deferred revenue at September 30, 1989; in accordance with generally accepted accounting principles, these funds will be recognized as contributed income when the funds are expended for the various exhibits.

During the past year or so, under Foundation sponsorship, three major exhibits have been opened: the exhibit of Electricity And Magnetism; the Wine Exhibit; and Life Style Choices. These amount to contributions of approximately \$2,000,000. The Report fails to recognize in any significant manner the above contributions by the Foundation.

Reading the Report, one would conclude that only the State Agency currently is raising funds for the Museum. As noted earlier, the combined efforts of the State Agency and the Foundation produce the private sector support.

Generally, the efforts of Foundation Trustees open the doors and obtain consideration of a contribution. Support then is provided by various members of the staff: the curators working for the State Agency; the curators working for the Foundation; or staff working for both. The Report specifically refers to the National Science Foundation grant of approximately \$300,000 towards planning for a chemistry exhibit, and states that this grant was solicited by State Agency employees -- of course, it was solicited by the person who was then the head of staff for both the State Agency and Foundation, a dual employee, supported by the curatorial staff. Not mentioned in the Report is that the remainder of the \$629,000 was raised by Foundation Trustees and that the total amount was a combined

partnership effort, including staff support from both the State Agency and the Foundation. Further, a major emphasis in the Report is on funds raised for the Urban Environment Exhibit. This is a fairly recent exhibit effort and State Agency employees (including a State Agency and Foundation dual employee) went to other California and local agencies for the initial money, amounting to approximately 15 percent of the total cost of the exhibit. Much of the remainder, approximately \$2,500,000, if it is raised, will necessarily be raised by the Foundation through its Trustees, utilizing all necessary staff, whether employed directly by the State Agency, the Foundation, or both.

V

THE REPORT IMPLIES THAT THE STATE AGENCY IS IMPROPERLY PROVIDING SUPPORT FOR THE FOUNDATION'S OPERATIONS AT THE REQUEST OF OR WITH THE CONSENT OF THE FOUNDATION

A major section of the Report is entitled "The [State Agency] Provides Substantial Financial Support For The Foundation's Operations." As stated above, the State Agency and the Foundation were for many years in a cooperative effort under which no particular distinction was drawn as to which of the entities was expending funds for administration expenses. One of the conditions of the State Agency's being able to enter into a new agreement with the

Foundation, however, was that no State Agency funds would be used to support the general operating costs of the Foundation. The Foundation has no objection to that provision and has made clear that if, in the general operations of the Foundation, some of the operating costs are being borne by the State Agency, the Foundation will promptly reimburse the State Agency upon request. The Foundation believes that the proper thrust of this section of the Report is that the State Agency's procedures must be improved so as to request reimbursement from the Foundation on a more regular basis. Moreover, as stated in the Report, 69% of the \$113,700 mentioned in the report was paid pursuant to written contracts entered into by the Foundation and the State Agency under contracting procedures believed by the Foundation to have been approved in Sacramento [see VI below].

VI

NO FOUNDATION EXPENSES ARE DEDUCTED FROM RENTAL
INCOME RECEIVED BY THE FOUNDATION UNDER THE
RESTAURANT AND GIFT SHOP CONCESSIONS; ALL SUCH
RENTAL INCOME IS UNDER THE SOLE AUTHORITY OF THE
STATE AGENCY

The Report discusses the contracts under which the Foundation has received rental income from the gift shops and the McDonalds' restaurant. It is true that the

Foundation did enter into contracts with the outside vendors. The Foundation understood that these contracts were authorized by the appropriate authorities of the State of California. The Report does acknowledge that in February, 1990 a new contract for the gift shops was entered into by the State Agency directly. The Foundation has no objection to adhering to any contracting procedures mandated by State law.

The most crucial point not made clear in the Report is that restricted accounts into which all of the rental payments are deposited are for the sole purpose of supporting the Museum's exhibits and that the expenditure of funds from these restricted accounts is only at the initiation of and under the sole direction of an employee of the State Agency. The Foundation is merely a conduit for these rental payments. The Foundation does not deduct any expenses from the rent received.

VII

CONCLUSION

The tenor of the Report would lead one to conclude that the Museum has not been well served by the Foundation and that the Foundation somehow is misusing funds for its own benefit rather than using them for the benefit of the Museum. The Foundation has existed and does exist solely

for the benefit of the Museum. The Foundation and its employees have worked hard to help make the Museum the fine one it is. It would be unfortunate for the report to lead laymen, legislators, and the media to draw a different conclusion.